Original

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Implementation of Sections of	)	
the Cable Television Consumer	)	MM Docket No. 92-266
Protection and Competition Act	)	
of 1992	)	
	)	
Rate Regulation	)	

REPLY OF
NATIONAL CABLE TELEVISION ASSOCIATION, INC.
TO OPPOSITIONS TO PETITIONS FOR RECONSIDERATION

The National Cable Television Association, Inc. ("NCTA") hereby replies to oppositions to its petition for reconsideration of the Commission's Report and Order in the above-captioned proceeding.

I. The Commission's "Unitary" Benchmark Scheme Is Contrary to the Act.

As we showed in our Petition for Reconsideration, the Act and its legislative history clearly mandate not only that there be two distinct procedural mechanisms for regulatory rates for basis service and rates for non-basic tiers of "cable programming services", but also that there be two distinct standards. For example:

- Regulation of a system's basic rates is explicitly intended to ensure that such rates not exceed what would be charged if the system were subject to effective competition. There is no such directive with respect to non-basic rates.

- The factors to be considered in establishing standards for basic rate regulation include the rate charged by comparable systems subject to effective competition. The factors to be considered in establishing standards for non-basic rate regulation include the rates charged by systems subject to effective competition and the rates charged by similarly situated cable systems not subject to effective competition -- indicating that only rates that significantly exceed the norm for such systems should be deemed unreasonable.

- The factors to be considered in establishing non-basic rate regulation explicitly include "the history of the rates for cable programming services, including the relationship of such rates it charges in general consumer

prices"[1] -- indicating that only where rates for non-basic tiers not only significantly exceed the norm but also have increased significantly more rapidly than inflation should they be deemed unreasonable.

- In regulating non-basic rates, the Act directs the Commission to consider "the rates, as a whole, for all the cable programming, cable equipment, and cable services provided by the system, other than programming provided on a per channel or per program basis"[2] -- indicating that the reasonableness of non-basic rates should depend on the overall rates charged for basic and non-basic services.

- The legislative history specifically states that only "a minority of cable operators have . . . unreasonably raised rates" during the period of deregulation[3] -- indicating that, while the Commission's rules may result in reductions of most systems' basic rates, the overall rates and revenues of only a minority of systems should be deemed unreasonable.

Several parties urge the Commission to retain its unitary benchmark scheme, but none explain how the Commission can do so in light of these clear directives and implications of the Act to the contrary. The National Association of Telecommunications Officers and Advisors, et al. (the "Cities") concede, in a footnote, that "the factors the Commission must take into account is establishing a cable programming service tier rate differ slightly from the factors it must consider in establishing a basic tier rate."[4] But they insist that these differences do not require different regulatory standards, so long as "such factors were taken into account in whatever method of regulation it chose."[5]

As we showed, the differences in the statutory factors are hardly "slight," and, in any event, the Cities nowhere explain precisely how the Commisison has, in fact, taken into account the factors that uniquely apply to non-basic rate regulation. How, for example, has the Commission taken into account the history of rates for cable programming services in determining whether such rates are unreasonable? How, in setting standards for non-basic rates,

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1 Act, Sec. 623(c)(2)(C)

2 Id., Sec. 623((c)(2)(D).

3 House Report at 68.

4 NATOA, et al. ("Cities") Opposition at 9 n.9 (emphasis added).

5 Id. See also King County, et al ("King County") Opposition at 24.

has the Commisison taken into account the rates, "as a whole", for all cable programming, equipment and services?

The Cities argue simply (and with no support from the Act or its legislative history) that "Congress intended for the Commission to eliminate monopoly rents in all cable service rates"[6] -- as if this obviated any need to come to grips with the different frameworks and factors that Congress set forth for regulating basic and non-basic rates.[7] And King County, Washington, et al. ("King County"), instead of attempting to rebut the clear statement in the House Report that only a "minority" of cable systems had unreasonable raised their rates, simply ignores it, flatly stating that "Congress made no finding that only a small portion of operators were charging excessive non-basic rates."[8]

There is, in short, no rebuttal to the clear directives of the Act and its legislative history. Benchmarks based on rates charged by systems subject to effective competition may be suitable for regulating basic rates. But standards for regulatory non-basic rates must be different -- and must, at least, take into account the history of a system's rates, the rates charged by all similarly situated systems (including those not subject to effective competition), and the overall rates charged by a system for basic and non-basic rates.

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6 Id. at 8 (emphasis in original).

7 The Cities argue that, putting aside the Act's explicit directives, the Commission's unitary benchmark scheme is beneficial because "[a]pplication of the same 'reasonable' benchmark standard to both basic and cable programming service tiers will eliminate any need for cable operators to retier programming from basic to other tiers in order to recover their costs." Id. This, of course, is not true. Many cable operators will have to retier services in order to adopt to a regulatory scheme in which the maximum permissible per-channel rates of all tiers are the same.

For example, some systems might currently offer low-priced basic tiers that consist primarily of broadcast signals and other low-cost services and higher-priced non-basic tiers that consist of higher-cost satellite services. In order to comply with the unitary benchmark, such systems may need to rearrange their tiers, so that the mix of services on each tier have roughly the same average per-channel costs and can be offered at the same per-channel price. It will no longer be possible for operators to offer one tier filled with low-priced services and one tier filled with higher-priced options. Indeed, the likely result, in the above example, is that basic rates will go up, while rates for non-basic service go down. There may be public policy reasons for this retiering and repricing, but neither the Commission nor the Cities have identified them.

8 King County Opposition at 24.

II. The Benchmarks Are Fundamentally Flawed.

In our petition for reconsideration, we pointed out three fundamental problems with the benchmarks that would need to be corrected if the Commission were to persist in applying the benchmarks not only to basic but also to non-basic rates. For the most part, the oppositions do not even attempt to show that these corrections are not necessary. Unless the Commission abandons its unitary approach, the corrections should be made.

A. Benchmarks Should Not be Based on Average Rates.

First, we showed that it made no sense to base competitive benchmarks on the average rates charged by systems subject to effective competition. All rates charged by systems subject to effective competition are, by definition, "competitive." Those rates may vary substantially because, among, other reasons, the costs of such systems vary substantially. But there is no reasons at all to assume that only rates that are at or below the mid-point of the range of rates charged by such systems are reasonable.

None of the oppositions appear to address, much less rebut, this argument. Accordingly, the Commission should recalculate its benchmark in a manner that recognizes that the rates of most systems subject to effective competition -- not merely those that are at or below the average -- are reasonable. At a minimum, if the Commission decides to retain its existing benchmarks, which are based on the average rates of systems subject to effective competition, it should create a zone of reasonableness around those benchmarks so that rates within a reasonable range of the benchmark would not be deemed unreasonable.

B. The Benchmarks Erroneously Assume a Uniform Difference Between Rates of Competitive and Non-Competitive Systems.

Second, we submitted a report from Economists Incorporated that showed that the current benchmarks were calculated on the basis of a wholly erroneous assumption. Specifically, the benchmarks incorporate an across-the-board ten percent downward adjustment to reflect the supposed fact that rates charged by systems subject to effective competition are, uniformly, ten percent lower than rates charged by systems not subject to effective competition. Economists Incorporated 's study demonstrates that, while the average rates charged by competitive and non-competitive systems vary by approximately 10 percent, this differential is hardly uniform.

Indeed, for systems with more than 5,000 subscribers, there are, on average, no significant differences in rates charged by competitive and non-competitive systems.

The implications of this finding, we thought, were obvious:

> For systems with more than 5,000 subscribers, a 10 percent reduction in rates is wholly unwarranted and will drive average rates to 10 percent below what systems subject to effective competition charge. Systems subject to effective competition -- which are presumed to be earning no more than a reasonable profit -- obviously could not survive such a rate reduction unless they could sharply cut back their expenditures on programming and facilities. There is no reason to expect that non-competitive systems could reduce rates to such levels, either.[9]

King County, however, seems not to understand these implications. It argues that our study does not

> explain why system size is a relevant factor, why it is the only additional factor that the FCC needs to consider, or how it determined that 5,000 or 10,000 subscribers should be the cast-off point between large and small systems.[10]

The point is that, for whatever reason, it appears to be the case that system size is a relevant factor and that, while there are significant differences between competitive and non-competitive systems with fewer than 5,000 subscribers, there are no such differences between such systems with more than 5,000 subscribers. Therefore, there is no basis for adopting benchmarks that are intended to reduce existing rates of such systems by 10 percent. King County is correct in pointing out that there may be other relevant factors and other ways to illustrate the same underlying problem, which is that the assumption of a uniform ten percent differential is erroneous. But that only confirms that the benchmarks, to the extent that they rely on such an erroneous assumption, cannot reasonably be applied to both basic and non-basic rates without forcing a substantial number of systems to charge non-compensatory rates or resort to cost-of-service showings. Therefore, either the benchmarks should only be applied to basic rates (with a more flexible standard applied to non-basic rates) or the across-the-board ten percent

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9 NCTA Petition at 15 (emphasis in original).

10 King County Opposition at 12.

adjustment should be revised so that there is no adjustment for systems with more than 5,000 subscribers.

C. The Benchmarks Prevent Systems From Adding New Channels of Quality Programming.

Third, we showed that, whether or not the benchmarks accurately reflected a snapshot of the rates charged by systems subject to effective competition on September 30, 1992, they could not be applied prospectively to non-basic tiers without effectively preventing cable operators from adding new, quality programming to those tiers. For whatever reason, the per-channel benchmarks decline so precipitously as the number of channels on a system increases that the marginal revenues that would be permitted for additional channels would rarely be sufficient to cover the costs of all but the least expensive programming. And they would certainly not cover the costs of upgrading or activating facilities to provide such channels.[11]

The Cities and other franchising authorities simply ignore this problem, perhaps because they would prefer that new services not be added if, as a result, rates must increase. Franchising authorities seem still to be incapable of recognizing that their constituents preferred the increased number of channels and the improved service that they received after rates were deregulated to the service that had been available at the lower rates that had been mandated by city regulators. Thus, King County, while acknowledging that the new benchmarks might reduce cash flow and make financing of cable systems more difficult, argues that the cable industry has "never demonstrate[d] that their existing financing is reasonable, that their past expenditures have been prudent, or that their financing and expenditures would exist in a competitive environment."[12] If there is one thing that the history of regulation and deregulation shows, it is that franchising authorities are poor judges of what level of expenditures by cable systems should be deemed prudent; when rates were deregulated, expenditures increased much more rapidly than before -- and so did penetration.

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11 Attachment A provides some illustrative examples of the extent to which benchmarks decline as the number of channels increase.

12 King County Opposition at 6 (emphasis added).

To the extent that the benchmarks provide a clear disincentive to adding new channels, they need to be fixed. The best approach, as we suggested, would be to apply the benchmarks only to basic rates while adopting a more flexible standard for non-basic rates. But if there is to be a unitary benchmark approach, the Commission needs to ensure that the benchmarks do not have the effect of stifling the addition of new channels and the development of new, high-quality program services.

III. The Range of "External Cost" Increases for Which Pass-Throughs Are Allowed Should Be Expanded.

In our petition for reconsideration, we argued that the Commisison had unduly limited the range of "external cost" increases that could be passed through as rate increases without invoking cost-of-service proceedings. We identified three specific types of costs that are not -- but should be -- treated as external costs by the rules: (1) costs of upgrading and rebuilding facilities; (2) cost of programming, even where the programmer and the cable operator are vertically integrated; and (3) costs attributable to retransmission consent.

A. Cost of Upgrading and Rebuilding Facilities.

The argument that increased costs that are attributable to rebuilding and upgrading facilities should be treated as external costs is not unrelated to the previously discussed problem that per-channel benchmark rates decline precipitously as additional channels are added. It is precisely because the benchmarks do not allow systems to recover the additional costs of increasing channel capacity and providing more programming that some additional way of passing through such costs is required.

Some parties are concerned that allowing pass-throughs for increased costs of rebuilds and upgrades would be improper to the extent that it, in effect, would force the "captive cable customer" of basic and non-basic tiers to subsidize other unregulated services.[13] To the extent feasible, pass-throughs for increased expenditures on facilities should only be allowed for that

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13 Michigan Communities Opposition at 18. See also BellSouth Comments at 4-6; Cities Opposition at 13-14. There is some irony to viewing basic cable subscribers as "captive ratepayers," similar to subscribers to basic telephone service. There is nothing essential about a tier of service that includes, primarily, local broadcast signals that are available at no charge over the air. If rates for basic service unfairly subsidized unregulated services, subscribers could simply refuse to buy basic service -- except that the Cable Act, at the behest of the broadcast industry, makes them "captives" by forcing them to buy basic service.

portion of the increased costs that are attributable to the provision of basic service and regulated cable programming services. But to the extent that even costs properly attributable to regulated basic and non-basic services are not recoverable through increased rates for those services, operators will be faced with two choices: Either (1) do not incur the costs of upgrading or rebuilding facilities; or (2) use the upgraded facilities to provide only unregulated services, such as programming provided on an a la carte basis.

The benchmarks alone could deal with these problems if, when a system used increased channel capacity to provide additional channels of regulated service, the per-channel benchmark rate were sufficient to cover the properly allocable costs of the capital improvements. But, as we have shown, the per-channel benchmarks decline so steeply when channels are added that it would generally be impossible to recover even the costs of the additional programming, much less the costs of the capital improvements. Unless this problem with the benchmarks is somehow fixed, some sort of pass-through for the costs of upgrades and rebuilds will be necessary to ensure that upgrades and rebuilds will be done and that upgraded facilities can be used to provide both regulated and unregulated services.

B. Costs of Vertically Integrated Programming and Retransmission Consent.

Our arguments involving programming cost pass-throughs -- both with respect to vertically integrated programming and with respect to retransmission consent -- are not specifically addressed or rebutted in the various oppositions. The Cities generally oppose any broadening of the definition of external costs and any additional pass-throughs, but their reasons reflect a misunderstanding of what the rules allow.

The Cities are fixated on the notion that allowing pass-throughs for external costs will somehow result in "double dipping" by cable operators:

> [E]xcept for franchise fees, the Commission's benchmark rates generally reflected all costs incurred by a cable operator. Cable operators should not be able to recover these costs a second time by treating them as external costs, such a recovery would be 'double dipping' by the operator.[14]

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[14] Cities Opposition at 12.

But the rules do not allow cable operators to pass through all external costs in addition to their allowable benchmark rate. All that they provide is that once a reasonable rate has been established, whether under the benchmarks or through cost-of-service proceedings, cable operators may subsequently increase rates annually by an amount that reflects inflation plus any increases in external costs, to the extent that such increases exceed inflation.

There is no "double dipping" to be found in such an approach. Benchmark rates reflect average costs incurred by cable operators as of September 30, 1992, and the initial determination of the reasonableness of a system's rates is based on those benchmarks. Going forward, a system's reasonable rates do not become unreasonable if they increase in an amount that reflects increased costs; rate increases that simply cover cost increases do not yield additional excess profits. Moreover, for the reasons set forth in our petition, it is unreasonable and illogical to carve out exceptions for programming that is provided to cable operators by affiliated programmers or by broadcasters pursuant to retransmission consent. Nothing in any of the oppositions provides any basis for these exceptions, and they should be deleted.

IV. The Commission Should Revise Its Equipment Rules.

In our petition, we identified several problems with the Commission's rules regarding equipment rates. Specifically, we argued (1) that the decision to subject virtually all equipment to "actual cost" regulation was not what the Act required or contemplated; (2) that while the Commission should require that rates for equipment, installations and additional outlets associated with basic service be designed to recover, overall, no more than actual cost plus a reasonable profit, operators should be allowed to charge less than actual cost for some items and more than actual cost for others; and (3) that, in any event, the "reasonable profit" that the rules allow is too small.

Except for the Cities, the parties opposing our petitions do not address these equipment issues -- and even the Cities only address the first issue. On this issue, they simply rehash the argument, set forth by the Commission, that in changing the language to apply to equipment "used" to receive basic service instead of equipment "necessary" to receive such service, Congress clearly meant to encompass all equipment that might be used in conjunction with

viewing basic service, "regardless of whether it is also used to receive any other programming service(s)."[15] Our petition specifically addressed this argument and demonstrated that it was erroneous. We explained that the purpose of the change in language was to ensure that the provision encompassed the one type of equipment that most concerned Congress -- remote control devices, which are never "necessary" to receive basic or non-basic service. Had Congress meant to subject virtually all equipment to "actual cost" regulation, it could and would have said so more directly. The Commission should apply "actual cost" requirements only to equipment leased to basic-only subscribers (or to basic-only subscribers who choose to purchase premium services without buying intermediate tiers, pursuant to the anti-buy-through provisions of the Act).

In any event, the Cities do not even address the other equipment issues that we raised. This reflects the reasonableness of our proposals on those issues. The Commission should, as we proposed, require only that overall equipment rates reflect actual cost plus a reasonable profit, and it should reject as too low its proposed allowance of only a 11.25 percent profit on equipment.

V. The Commission Should Ease the Regulatory Burdens of Small Systems.

Finally, the Act requires that the Commission design its regulations "to reduce the administrative burdens and cost of compliance for cable systems that have 1,000 or fewer subscribers."[16] The Commission's rules have not addressed the problems of small systems in any meaningful way, and we urge the Commission to adopt those measures set forth in the letter submitted in this proceeding on July 13, 1993 by NCTA, the Community Antenna Television Association, the Small Cable Business Association, and the Coalition of Small System Operators.[17]

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15 Id. at 21.

16 47 U.S.C. Sec. 623(i).

17 See Letter to Chairman James H. Quello, July 13, 1993.

CONCLUSION

For the foregoing reasons, and for the reasons set forth in NCTA's Petition for Reconsideration, that Petition should in all respects be granted.

Respectfully submitted,

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ATTACHMENT A

Scenario 1

If a 10,000 subscriber system offered 30 channels of basic service (including 20 satellite channels), the system could charge $0.693 per channel or $20.79. If the system decided to add five satellite channels, the system's new benchmark rate would decrease to $0.618 per channel, or $21.63. Therefore, by adding five satellite channels, the system would only be able to generate $0.84 in additional revenue, or 16.8 cents per additional channel.

Likewise, if the system had decided to add ten additional satellite channels, the system's benchmark rate would have dropped to $0.559 per channel, or $22.36. By adding ten satellite channels, the system would generate only $1.57 in additional revenue, or 15.7 cents per additional channel.

Scenario 2

If a 10,000 subscriber system offered 35 channels of basic service (including 20 satellite channels), the system could charge $0.604 per channel or $21.14. If the system decided to add five additional satellite channels, the system's new benchmark rate would decrease to $0.549 per channel or $21.96. Therefore, by adding five satellite channels, the system would only be able to generate $0.82 in additional revenue, or 16.4 cents per additional channel.

Likewise, if the system had decided to add ten additional satellite channels, the system's benchmark rate would have dropped to $0.504 per channel, or $22.68. By adding ten satellite channels, the system would generate only $1.54 in additional revenue, or 15.4 cents per additional channel.

Scenario 3

If a 10,000 subscriber system offered 40 channels of basic service (including 25 satellite channels), the system could charge $0.549 per channel or $21.96. If the system decided to add five additional satellite channels, the system's new benchmark rate would decrease to $0.504 per channel or $22.68. Therefore, by adding five satellite channels, the system would only be able to generate $0.72 in additional revenue, or 14.4 cents per additional channel.

Likewise, if the system had decided to add ten satellite channels, the system's benchmark rate would have dropped to $0.466 per channel, or $23.30. By adding ten satellite channels, the system would generate only $1.34 in additional revenue, or 13.4 cents per additional channel.